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Shareholder to Intermediary: "Thanks...It Is 'Appreciated'!"

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Shareholder to Intermediary: “Thanks . . . It Is ‘Appreciated’!”

TERRI GUINN*

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I. INTRODUCTION

In simple terms, an intermediary transaction tax shelter comprises (1) a seller who desires to sell stock of a “target” corporation, (2) an intermediary corporation, (3) a purchaser who desires to purchase the assets rather than the stock of the target, and (4) an accompanying tax liability that is triggered on the sale of these assets.¹ This Casenote examines the extent of the seller’s tax liability in such a transaction as

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1. See I.R.S. Notice 2001-16, 2001-1 C.B. 730.

set forth under the recent case of *Starnes v. Commissioner*.² Before turning to the case, it may be helpful to consider the following hypothetical.

Suppose a seller owns 100% of a target corporation, in which he has a basis of \$5 million. The target has appreciated assets with a total fair market value of \$10 million and a basis of \$5 million. A purchaser wants to buy the target's assets. The target will recognize a gain of \$5 million upon selling the assets to the purchaser outright for \$10 million.³ If the target's gain is taxed at 35%, for example, the target will have a \$1.75 million corporate tax liability resulting from the sale.⁴ If the seller causes the target to liquidate, the seller will be taxed as if he sold his stock for the \$10 million liquidation proceeds less the target's tax liability of \$1.75 million—the seller will be taxed on the \$8.25 million realized. If the seller's gain is taxed at 15%, then the seller will have a \$487,500 tax liability.⁵ Accordingly, the seller's net after-tax profit will be \$2,762,500.⁶ Ultimately, the purchaser obtains a \$10 million fair market value in the assets, the target pays \$1.75 million in taxes, the seller pays \$487,500 in taxes, and, in total, the IRS collects \$2,237,500 in taxes on this transaction.⁷

2. 101 T.C.M. (CCH) 1283 (2011), *aff'd*, 680 F.3d 417 (4th Cir. 2012). The Internal Revenue Service appealed this case to the United States Court of Appeals for the Fourth Circuit, which affirmed the Tax Court's *Starnes* decision on May 31, 2012. *Starnes*, 680 F.3d 417.

3. \$10 million amount realized – \$5 million basis = \$5 million gain.

4. See I.R.C. § 11(b)(1) (2006). Internal Revenue Code § 11(b)(1) sets forth the general rule for calculating the actual amount of tax imposed on corporations as follows:

The amount of the tax imposed by subsection (a) shall be the sum of—

(A) 15 percent of so much of the taxable income as does not exceed \$50,000,

(B) 25 percent of so much of the taxable income as exceeds \$50,000 but does not exceed \$75,000,

(C) 34 percent of so much of the taxable income as exceeds \$75,000 but does not exceed \$10,000,000, and

(D) 35 percent of so much of the taxable income as exceeds \$10,000,000.

In the case of a corporation which has taxable income in excess of \$100,000 for any taxable year, the amount of tax determined under the preceding sentence for such taxable year shall be increased by the lesser of (i) 5 percent of such excess, or (ii) \$11,750. In the case of a corporation which has taxable income in excess of \$15,000,000, the amount of the tax determined under the foregoing provisions of this paragraph shall be increased by an additional amount equal to the lesser of (i) 3 percent of such excess, or (ii) \$100,000.

Id.

5. Net capital gain is taxed at 15% for taxpayers in the 25% tax bracket. I.R.C. § 1(h)(1)(C) (2006).

6. \$8.25 million amount realized – \$5 million basis = \$3.25 million gain. \$3.25 million gain – \$487,500 capital gains tax = \$2,762,500 gain after tax.

7. \$1.75 million taxes at the corporate level + \$487,500 taxes at the shareholder level = \$2,237,500 total taxes.

Now, consider a second scenario where after the target sells its assets to the purchaser, the seller sells its target stock for \$10 million to an unrelated intermediary, which expects to generate tax losses inside the target to offset the target's gain from the sale of its assets.⁸ If the seller is taxed on the gain from the stock sale at 15%, then the seller will have a \$750,000 tax liability.⁹ The seller's net after-tax profit will be \$4.25 million, which is \$1,487,500 more than the seller's net after-tax profit in the first scenario.¹⁰ Ultimately, the purchaser will still obtain a \$10 million fair market value basis in the assets and the seller will pay \$750,000 in taxes. Although gain will still be realized inside the target,¹¹ if all goes well, the intermediary will have sufficient tax attributes to offset the gain and eliminate the target's tax liability. In total, the Internal Revenue Service (IRS) will only collect \$750,000 in taxes—as opposed to \$2,237,500—with the difference instead going directly to the seller.

Typically, the IRS identifies the second scenario as an intermediary transaction tax shelter or “Midco” transaction.¹² As such, the IRS collapses the steps in the transaction, thereby disregarding the intermediary's role and recasting the transaction much like the first scenario.¹³ Not only will

8. This is a simplified example. In reality, the intermediary will expect to be compensated for providing its favorable tax attributes and services to the seller. See Thomas W. Avent & Patricia M. Rubirosa, *Not All Three-Party Transactions Are Created Equal*, CORP. BUS. TAX'N MONTHLY, May 2003, at 3, 7. For instance, the intermediary might pay the seller less than \$10 million for the stock but more than the \$8.25 million the seller would receive in the first scenario. See *id.* The intermediary would keep the difference between the \$10 million value of the stock and the actual amount it paid for the stock as a fee for its services. See *id.*

9. \$10 million amount realized – \$5 million basis in the stock = \$5 million gain.

10. \$10 million amount realized – \$5 million basis in the stock – \$750,000 tax liability = \$4.25 million net after tax profit.

11. The entity-level tax that corporations pay on their income is often referred to as “inside” tax on “inside gain.” Paul B. Stephan III, *Disaggregation and Subchapter C: Rethinking Corporate Tax Reform*, 76 VA. L. REV. 655, 666 (1990). The tax that the shareholders pay on corporate distributions of after-tax earnings or on the sale of their stock is often referred to as “outside” tax on “outside gain.” *Id.*

12. Intermediary transactions—Midcos—were first identified as “listed transactions” by the IRS in Notice 2001-16, later clarified by Notice 2008-111. I.R.S. Notice 2001-16, 2001-1 C.B. 730; I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299. In a basic intermediary transaction, an intermediary company (*M*) buys the stock of a target corporation (*T*) from the shareholders (*X*) and then sells the newly acquired company's assets to a buyer (*Y*) under a predetermined plan. I.R.S. Notice 2001-16, 2001-1 C.B. 730. *Y* then claims a tax basis in the assets equal to the price paid, and *M* uses various tax strategies to offset the otherwise reportable gain on the sale of *T*'s assets. *Id.*

13. In Notice 2001-16, the IRS stated that it would challenge intermediary transactions by recharacterizing them as one of the following: a sale of *T* stock to *Y* by *X*,

the IRS assert a deficiency against the target, but it may also impose severe penalties under various Internal Revenue Code sections.¹⁴ If the target transfers its assets beyond the reach of the IRS, then the IRS will allege the transfer was fraudulent and demand that the assets be returned to the target so that the IRS can collect the taxes.¹⁵ In the alternative, the IRS may impose transferee liability on the selling shareholders to the extent of the target's liability pursuant to I.R.C. § 6901.¹⁶ To avoid these legal ramifications, a seller should follow the first scenario and experience two levels of taxation on the sale of the target's appreciated property—first at the corporate level and then again at the shareholder level—in order for the purchaser to receive the assets with a step-up in basis.¹⁷

In the recent case of *Starnes v. Commissioner*, however, the selling shareholders engaged in a transaction substantially similar to a Midco transaction.¹⁸ In that case, the target corporation subsequently transferred its remaining cash beyond the IRS's reach, yet the Tax Court found that the cash was not fraudulently transferred.¹⁹ Thus, the IRS was unable to

in which case *Y* would not get a step-up in basis in the assets; a sale of *T*'s assets while *T* is still owned by *X*, in which case *T* would be liable for a corporate-level tax on the gain from the sale and could not use any of the offsetting losses provided by *M*; or as otherwise appropriate depending on the facts. *Id.* The notice also set forth various penalties that the IRS could impose against participants or their advisors. *See id.*

14. *See* I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299. These penalties include the following: a \$200,000 penalty for a participant's failure to disclose a listed transaction pursuant to § 6707A; a \$200,000 penalty or a penalty of 50–75% of gross income derived for a material advisor's failure to make a disclosure pursuant to § 6707(a); a \$10,000-per-day penalty for a material advisor's failure to provide a list of persons advised in connection with the transaction pursuant to § 6708(a); an excise-tax, disclosure, filing, or payment obligation on tax-exempt investors and entity managers that invest in listed transactions pursuant to §§ 4965, 6033(a)(2), 6011, and 6071; a 20% penalty for underpayments related to negligence, substantial understatements, or reportable transactions pursuant to § 6662(a); a preparer penalty under § 6694; a promoter penalty under § 6700; an aiding-and-abetting penalty under § 6701; and the extension of the statute of limitations on the assessment for a person's failure to disclose reportable transactions under § 6501(c)(10). I.R.C. §§ 6707, 6707A, 6708(a), 6662 (2006); I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299. Unless otherwise noted, all code sections in this Casenote are in reference to the Internal Revenue Code.

15. *See id.*

16. *See* Richard M. Wise, *Transferee Tax Liability*, ST. LOUIS B. J., Summer 1996, at 47, 49.

17. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 5 (7th ed. 2008). The purchaser's stepped-up basis in the assets will be the actual cost of the assets rather than the target's historic basis in the assets. *See* I.R.C. § 1012 (2006 & Supp. 2011). If the purchaser were instead to purchase the seller's stock, the purchaser would obtain the assets with a "transferred" basis from the target. *See* I.R.C. § 7701(a)(43) (2006).

18. *See* *Starnes v. Comm'r*, 101 T.C.M. (CCH) 1283, 1284–87 (2011), *aff'd*, 680 F.3d 417 (4th Cir. 2012).

19. *Id.* at 1288–89, 1291.

collect the target's unpaid taxes from either the target directly or the shareholders under the theory of transferee liability.²⁰ This decision could effectively amount to a return of the *General Utilities* doctrine, where selling shareholders were able to avoid paying a corporate-level tax on the sale of appreciated target assets while purchasers were nevertheless able to obtain a stepped-up basis in the assets.²¹

Part II of this Casenote explores the history behind the *General Utilities* doctrine, and Part III explains why the doctrine was ultimately repealed.²² Part IV then analyzes *Starnes* and how it could lead to the resurrection of the *General Utilities* doctrine through the use of intermediaries.²³ Finally, Part V concludes by drawing attention to the ease with which other shareholders, eager to avoid a corporate-level tax, could replicate the *Starnes* transaction.²⁴

II. THE *GENERAL UTILITIES* DOCTRINE

Subchapter C of the Internal Revenue Code is a double-tax regime wherein profits from the sale of appreciated corporate property are taxed once to the corporation when it sells its property and again to the shareholders when the sales proceeds are distributed.²⁵ In *General Utilities & Operating Co. v. Helvering*, the shareholders of General Utilities Company hoped to escape the large corporate-level tax that would be imposed on the corporation if it sold its property directly to a prospective buyer by having General Utilities first distribute the property to its shareholders.²⁶ Shortly thereafter, the shareholders sold the property to the buyer on the same terms negotiated by the corporation.²⁷

20. See *id.* at 1286–87, 1291.

21. See Lily Kahng, *Resurrecting the General Utilities Doctrine*, 39 B.C. L. REV. 1087, 1110 (1998).

22. See *infra* Parts II–III.

23. See *infra* Part IV.

24. See *infra* Part V.

25. LIND ET AL., *supra* note 17, at 5. The requirement that the corporation recognize the gain or loss on the sale or exchange of its property is found in § 1001(c). I.R.C. § 1001(c) (2006). If the proceeds are distributed to the shareholders in the form of a dividend, the distribution must be taxed to the shareholders as a dividend pursuant to § 301(c)(1). I.R.C. § 301(c)(1) (2006). If the proceeds are distributed to the shareholders in redemption of stock or in complete liquidation, the amounts received by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock pursuant to §§ 302(a) and 331(a) respectively. I.R.C. §§ 302(a), 331(a) (2006).

26. *Gen. Utils. & Operating Co. v. Helvering*, 296 U.S. 200, 201–03 (1935).

27. *Id.* at 202–03.

The Court held that the corporation did not recognize any gain because the distribution was not a “sale” and the corporation did not discharge any indebtedness by distributing the appreciated assets.²⁸

This decision created a significant tax distinction between two economically equivalent transactions: (1) a corporation’s direct sale of appreciated property followed by the corporation’s distribution of the proceeds to the shareholders; and (2) a corporation’s distribution of that same property to its shareholders followed by the shareholders’ sale of the property.²⁹ If the corporation sold its appreciated assets to a purchaser, then the corporation would recognize gain and correspondingly increase its earnings and profits.³⁰ The shareholders would also be taxed to the extent of the corporation’s earnings and profits upon receipt of the sale proceeds in a corporate distribution.³¹ However, if the corporation first distributed the appreciated property to the shareholders, then the shareholders would be taxed on the distribution, but the property’s appreciation would escape taxation at the corporate level, and the purchaser would still obtain the property with a fair market value.³²

Despite the incongruity between distributions and sales created under *General Utilities*, Congress codified the case’s holding in the Internal Revenue Code of 1954 by enacting § 311(a), which provided that a corporation did not ordinarily recognize gain or loss on a nonliquidating distribution of property.³³ The IRS further amplified § 311 by extending the doctrine to include property distributions made in redemption of stock.³⁴ Congress also enacted §§ 336 and 346 in the 1954 Code, which

28. *Id.* at 206. The government’s opposing argument was that *General Utilities* should have been taxed on the distribution because the corporation created indebtedness to its shareholders by declaring a dividend and used appreciated property to discharge that debt, which was a taxable event. *Id.* at 204.

29. See LINDE ET AL., *supra* note 17, at 175.

30. *Id.*

31. *Id.*

32. *Id.* To illustrate the disparate tax treatment of distributions and sales resulting from the *General Utilities* doctrine, assume that the sole shareholder of a target corporation has a \$100,000 basis in target stock. The target’s only asset has a fair market value of \$500,000 and a \$0 adjusted basis. A purchaser desires to acquire the asset for \$500,000 cash. If the target distributes the asset to the shareholder first, the target recognizes no gain under the *General Utilities* doctrine. On a sale of the asset to the purchaser for \$500,000 following the distribution, the shareholder will recognize gain at the shareholder level measured by the difference between the shareholder’s basis in the target stock and the fair market value of the property, and the purchaser will obtain a stepped-up basis in the asset. If, however, the target sells the asset directly to the purchaser, the purchaser will still obtain a stepped-up basis in the asset, but the target will have to recognize a \$500,000 gain, and the shareholder will also recognize gain on the distribution of the after-tax sale proceeds, thereby resulting in double taxation. See *id.*

33. See I.R.C. § 311(a)(2) (1954) (current version at I.R.C. § 311(a)(2) (2006)).

34. Treas. Reg. § 1.311-1(a) (1957).

provided similar nonrecognition rules for liquidating and partially liquidating distributions.³⁵ Finally, Congress went even further by providing nonrecognition rules under § 337 for liquidating sales of assets followed by distributions of the proceeds to shareholders.³⁶

Shortly after Congress broadened the scope of the *General Utilities* doctrine, tax scholars began calling for its repeal.³⁷ These scholars asserted that corporations should not be exempt from tax on the disposition of appreciated property simply because shareholders were taxed on the transaction at the shareholder level.³⁸ However, outside of the academic community there was minimal opposition to the *General Utilities* doctrine because many legislators and businesses disliked double taxation, and the doctrine provided some relief from this system.³⁹ Others who defended the doctrine noted that if it were repealed, then the additional

35. I.R.C. §§ 336, 346 (1954) (current versions at I.R.C. §§ 336, 346 (2006)).

36. I.R.C. § 337 (1954) (current version at I.R.C. § 337 (2006)). Prior to the 1954 Code, even though a liquidating corporation's sale of its assets followed by a distribution of the proceeds to its shareholders was economically equivalent to the corporation's distribution of all of its assets to its shareholders followed by the shareholders' sale of the assets, the latter process had much more favorable tax results. See LIND ET AL., *supra* note 17, at 338. This motivated taxpayers to delay the sale of corporate assets until after liquidation in order to avoid a corporate-level tax. *Id.* This strategy was successful in *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950). See *id.* at 455–56; Kahng, *supra* note 21, at 1089. But in *Commissioner v. Court Holding Co.*, the Court came to the opposite conclusion, holding that a corporate liquidation followed by a shareholder asset sale was, in substance, a corporate asset sale followed by liquidation, thereby resulting in corporate gain recognition. *Comm'r v. Court Holding Co.*, 324 U.S. 331, 333–34 (1945); Kahng, *supra* note 21, at 1089.

Congress then codified *Cumberland* by permitting a corporation to avoid gain recognition upon the sale of its assets so long as the corporation distributed the sale proceeds to shareholders in complete liquidation of the selling corporation. Kahng, *supra* note 21, at 1089. By doing so, Congress broadened the scope of the *General Utilities* doctrine by providing corporate nonrecognition not only for distributions of appreciated property but also for liquidating sales. *Id.* This eliminated the disparate treatment between distributions and liquidating sales. See LIND ET AL., *supra* note 17, at 343. Under either scenario, the corporation did not recognize gain or loss, the shareholder recognized gain on the distribution of the assets—or the proceeds from the sale of the assets—and the buyer obtained a fair-market-value basis in the assets. *Id.* As a result, the only tax involved in a distribution or liquidating sale of assets was simply the capital gain recognized at the shareholder level. *Id.*

37. Kahng, *supra* note 21, at 1093.

38. See LIND ET AL., *supra* note 17, at 343.

39. See *id.*; George K. Yin, *General Utilities Repeal: Is Tax Reform Really Going To Pass It By?*, 31 TAX NOTES 1111, 1117 (1986).

tax would, in many cases, be imposed on merely inflationary gains of closely held family businesses.⁴⁰

III. REPEAL OF THE *GENERAL UTILITIES* DOCTRINE

Despite these arguments in favor of the *General Utilities* doctrine, Congress placed restrictions on the doctrine in the Tax Reform Act of 1969.⁴¹ After the initial codification of the doctrine in 1954, a corporation wishing to dispose of appreciated property would generally not sell the property but would instead redeem a portion of its own stock in exchange for the property so as to avoid recognition of gain at the corporate level.⁴² Congress perceived this as an abuse and thus enacted § 311(d) in the 1969 Act.⁴³ This new provision appeared to be an outright repeal of the *General Utilities* doctrine with respect to redemptions, but it was filled with exceptions.⁴⁴ Yet even with the 1969

40. See *Reform of Corporate Taxation: Hearing Before the S. Comm. on Fin.*, 98th Cong. 151 (1983) (statement of John S. Nolan, Partner, Miller & Chevalier). This was because closely held family businesses were more likely to undergo complete liquidations than large publicly held companies. See *id.*; John S. Nolan, *Taxing Corporate Distributions of Appreciated Property: Repeal of the General Utilities Doctrine and Relief Measures*, 22 SAN DIEGO L. REV. 97, 101 (1985).

41. David Scott Sloan & John M. Loalbo, *The Ultimate Disposition of General Utilities: An Analysis of the General Utilities Doctrine from Inception to Repeal*, 6 B.U. J. TAX L. 177, 184–85 (1988).

42. See *id.* at 184. This strategy was commonly employed by insurance companies, which had large investment portfolios of appreciated stock in other companies. *Id.* at 184–85. Rather than sell the stock, the insurance companies would redeem a portion of their own shareholders' stock in exchange for the appreciated portfolio investments. *Id.* at 185.

43. *Id.*

44. See *id.*; I.R.C. § 311(d) (1969) (current version at I.R.C. § 311 (2006)). Section 311(d) provided that if a corporation disposed of its property through redemption, the corporation was deemed to have sold its property for its fair market value and subsequently completed the redemption with the proceeds of the sale. See *id.* With respect to exceptions, § 311(a) nonrecognition still applied to the following redemption transactions found in § 311(d)(2)(A)–(G):

- a. a redemption in complete termination of a shareholder's interest . . . , if he had owned at least 10% of the corporation's stock for the twelve-month period ending on the date of the redemption distribution;
- b. a distribution of the stock or obligation of a corporation engaged in business, if it had not received a substantial portion of its assets in a section 351 transaction within the five-year period ending on the distribution date and if at least 50% of its stock had been owned by the distributing corporation at any time within the nine-year period ending one year before the distribution;
- c. a distribution pursuant to certain antitrust decrees;
- d. a distribution to which section 303(a) applied;
- e. a distribution to a private foundation;
- f. a distribution by a regulated investment company; and
- g. a distribution pursuant to the Bank Holding Company Act.

Act in place, nonrecognition rules still applied to property dividends, liquidating distributions, partially liquidating distributions, and liquidating sales.⁴⁵

Although repeal of the *General Utilities* doctrine was occurring gradually, movement toward complete legislative reform began gaining momentum in the 1980s.⁴⁶ In 1982, Congress adopted the Tax Equity and Fiscal Responsibility Act (TEFRA), which eliminated nonrecognition for distributions made in partial liquidation.⁴⁷ But TEFRA also took a step back in the movement toward repeal of the *General Utilities* doctrine by enacting § 338, which enabled purchasing corporations to treat certain stock purchases as asset purchases so as to obtain a stepped-up basis in the assets.⁴⁸ If an acquiring corporation made a § 338 election, pursuant to § 337 the target would be treated as if it sold all of its assets at the close of the acquisition date and subsequently repurchased those assets.⁴⁹ Because § 337 allowed for nonrecognition in liquidating sales, the target would recognize no gain or loss on the deemed sale of the assets, yet the purchasing corporation would still receive a tax-free stepped-up basis in the assets.⁵⁰

Congress once again moved closer to complete repeal of the *General Utilities* doctrine with the Deficit Reduction Act of 1984.⁵¹ Seeking to “revert back to a general rule of gain recognition which would be

Bernard Wolfman et al., *Taxing Corporate Distributions of Appreciated Property: Repeal of General Utilities Doctrine, Relief Measures and Entity Reclassification Proposals*, 22 SAN DIEGO L. REV. 77 app. at 89–90 (1985) (citations omitted).

45. See Sloan & Loalbo, *supra* note 41, at 186.

46. See LIND ET AL., *supra* note 17, at 343.

47. See Sloan & Loalbo, *supra* note 41, at 186. Appreciated, straight dividend, and complete liquidation distributions as well as liquidating sales, however, remained immune from tax at the corporate level. See Wolfman et al., *supra* note 44, at 90. Moreover, even though the *General Utilities* doctrine was repealed with respect to distributions made in partial liquidations under TEFRA, there was still an exception providing nonrecognition for distributions of qualified stock made to a noncorporate shareholder who owned at least 10% of the corporation’s stock and held such stock for at least five years prior to the partial liquidation. I.R.C. § 311(e)(1)(A) (1982) (current version at I.R.C. § 311); Sloan & Loalbo, *supra* note 41, at 190.

48. See Sloan & Loalbo, *supra* note 41, at 192–93.

49. *Id.* Prior to TEFRA, an acquiring corporation could achieve a stepped-up basis for some target assets while avoiding unfavorable tax treatment for other assets by structuring the acquisition as a partial purchase of assets and a partial purchase of stock. *Id.* at 192. TEFRA attempted to alleviate this inconsistency by enacting § 338, thereby requiring corporations to treat certain stock purchases as asset purchases. *Id.*

50. See *id.* at 193.

51. See *id.* at 196.

consistent with the ‘double tax system’ of corporations and shareholders,” Congress modified § 311(d) to require gain recognition on corporate distributions of appreciated property in redemptions, partial liquidations, and property dividends.⁵²

Finally, Congress completely repealed the *General Utilities* doctrine in the Tax Reform Act of 1986, even with respect to liquidating distributions and sales pursuant to §§ 336 and 337.⁵³ The 1986 Act also restricted the tax benefits of § 338(a) as set forth under TEFRA.⁵⁴ A purchaser who acquired the stock of a target corporation could still make a § 338(a) election and receive a stepped-up basis in the target assets, but because the target’s deemed sale of the assets would no longer be tax free under § 337, purchasers rarely made the election.⁵⁵

Complete repeal of the *General Utilities* doctrine ultimately came about not only because it had become exceedingly complex and riddled with exceptions but also because Congress believed that it tended to undermine the corporate income tax system.⁵⁶ Under normally applicable

52. *Id.* (quoting H.R. REP. NO. 98-432, pt. 2, at 1190 (1984)); see Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 54, 98 Stat. 494, 568 (codified at I.R.C. § 311(d)(1) (1984) (current version at I.R.C. § 311)). With respect to exceptions, nonrecognition still applied to the following:

- 1) a distribution of at least 50% of the value of stock or obligations of a controlled corporation to a qualified shareholder;
- 2) a distribution pursuant to a § 303 redemption;
- 3) a distribution to a private foundation in redemption of § 537(b)(2)(A) stock; [and]
- 4) a distribution by a regulated investment company in redemption of stock upon the demand of a shareholder.

Sloan & Loalbo, *supra* note 41, at 197 (citations omitted).

53. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269–72 (codified as amended at I.R.C. §§ 336–337 (2006)). Now, a liquidating corporation must recognize gain or loss on the distribution of property in complete liquidation as if the property were sold to the distributee at its fair market value. I.R.C. § 336(a). By modifying the law in this way, Congress greatly increased the tax cost of a complete liquidation because when a corporation makes a liquidating distribution of appreciated property, there will typically be tax at the corporate level as well as the shareholder level. LIND ET AL., *supra* note 17, at 345.

54. See Sloan & Loalbo, *supra* note 41, at 202–03.

55. See *id.* at 203. Stock purchasers who want to obtain a stepped-up basis in the target assets may instead make a § 338(h)(10) election if the target is a member of an affiliated group of corporations. See I.R.C. § 338(h)(10) (2006). One of the benefits of a § 338(h)(10) election is that it allows the target to be treated as a member of the affiliated group for purposes of the deemed sale. See *id.* Thus, if the group has losses elsewhere, these can be used to offset the gain from the target’s deemed sale. See *id.*

56. H.R. REP. NO. 99-426, at 281 (1985). Another reason Congress finally repealed the *General Utilities* doctrine in the liquidation setting was because the doctrine produced “many incongruities and inequities in the tax system.” *Id.* The House Ways and Means Committee believed that as a result of the doctrine,

[e]conomically, a liquidating distribution [was] indistinguishable from a nonliquidating distribution; yet the Code provide[d] a substantial preference for the former. A corporation acquiring the assets of a liquidating corporation

tax principles, a corporation could only escape taxation on its gains from the disposition of appreciated property if the recipient obtained a carryover basis in the transferred property.⁵⁷ This practice assured that any appreciation would eventually be taxed.⁵⁸ Under the *General Utilities* doctrine, however, a corporation could dispose of its property without experiencing a corporate-level tax while the recipient could still obtain a stepped-up basis in the assets.⁵⁹ After the doctrine was repealed, a corporation was required to recognize full gain on redemptions, property dividends, liquidating distributions, partially liquidating distributions, and liquidating sales.⁶⁰ Moreover, the purchaser of a target corporation's stock could no longer elect to have the target corporation step up its asset basis tax-free by making a § 338(a) election.⁶¹

IV. STARNES V. COMMISSIONER

The tensions created by the *General Utilities* doctrine finally appeared to be resolved when the doctrine was completely repealed in 1986.⁶² Since then, repeal of the doctrine has come to stand for the proposition that a corporation will generally be taxed at the corporate level when it divests itself of its appreciated assets, regardless of how the assets are divested, if a purchaser is to obtain a stepped-up basis in the assets.⁶³

[was] able to obtain a basis in assets equal to their fair market value, although the transferor recognize[d] no gain (other than possibly recapture amounts) on the sale. The tax benefits may [have made] the assets more valuable in the hands of the transferee than in the hands of the present owner. The effect may [have been] to induce corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might [have] indicate[d] a different course of action. Accordingly, the *General Utilities* rule may [have been] responsible, at least in part, for the dramatic increase in corporate mergers and acquisitions The committee believe[d] that the Code should not artificially encourage corporate liquidations and acquisitions, and believe[d] that repeal of the *General Utilities* rule [was] a major step towards that goal.

Id. at 281–82.

57. *Id.* at 282.

58. *Id.*

59. *Id.*

60. See Kahng, *supra* note 21, at 1096.

61. See *id.*

62. See *id.*

63. See *id.* Taxpayers did not accept this proposition easily. See Avent & Rubirosa, *supra* note 8, at 4. Rather, many taxpayers began participating in complex transactions, such as mirror subsidiaries transactions and son-of-mirror transactions, in efforts to bypass the corporate-level tax on the sale of appreciated property or obtain a

Yet the Tax Court's decision in *Starnes* may once again provide selling shareholders with an opportunity to avoid paying taxes at the corporate level while nevertheless providing purchasers with an unwarranted step up in basis.⁶⁴ But shareholders following *Starnes* will not achieve this end by avoiding the *existence* of a corporate-level tax on the distribution or sale of their assets as was provided under the *General Utilities* doctrine.⁶⁵ Rather, shareholders will achieve this by placing the target's corporate-level tax in an intermediary entity with offsetting tax attributes, which subsequently transfers the target assets out of the reach of the IRS.⁶⁶

A. The Facts

In *Starnes*, the parties participated in a transaction resembling a typical Midco transaction.⁶⁷ In early 2003, the shareholders of Tarcon, Inc. negotiated for the sale of its real estate to a third party, ProLogis.⁶⁸ The shareholders then met with representatives of MidCoast Investments, Inc., who proposed to purchase the stock of Tarcon.⁶⁹ The MidCoast representatives assured Tarcon shareholders that Tarcon would continue to operate under MidCoast's ownership and that Tarcon's 2003 tax liabilities would be paid.⁷⁰ In October 2003, Tarcon completed the sale of its real estate to ProLogis for \$3.18 million, thereby creating a federal and

tax-free, stepped-up basis in assets. *Id.* But Congress amended statutory provisions and the Treasury promulgated regulations to suppress these transactions when it became apparent that they were abusive. *See id.*

64. *See Starnes v. Comm'r*, 101 T.C.M. (CCH) 1283 (2011), *aff'd*, 680 F.3d 417 (4th Cir. 2012).

65. *See Avent & Rubirosa*, *supra* note 8, at 6.

66. *See id.* at 6–7.

67. Genelle Forsberg, *Midco Decisions in Tax Court*, GENELLE FORSBERG LAW OFFICE, <http://www.forsberglaw.com/whatsnew.htm> (last visited June 3, 2012).

68. *Starnes*, 101 T.C.M. (CCH) at 1284. Tarcon was a corporation organized in North Carolina in 1956 that operated a freight consolidation business. *Id.* Tarcon's business operations and revenues declined in the 1980s because of deregulation of the trucking industry. *Id.* By 2003, Tarcon had discontinued its freight consolidation business, and its primary business was leasing warehouse space of approximately 201,600 square feet on Granite Street in Charlotte, North Carolina. *Id.* The buyer interested in this Granite Street property, ProLogis, was a Maryland real estate investment trust. *See* Opening Brief for the Appellant at 6, *Starnes*, 680 F.3d 417 (No. 11-1636).

69. *Starnes*, 101 T.C.M. (CCH) at 1284–85. MidCoast claimed that it was interested in acquiring Tarcon's stock because it was “an effective way to grow [its] parent company's core asset recovery operations.” *Id.* at 1284.

70. *Id.* at 1285. In the brochure MidCoast sent to Tarcon agents, MidCoast asserted that it would put Tarcon into its “asset recovery business” and operate Tarcon on a “go-forward basis.” *Id.* at 1284. MidCoast further asserted that Tarcon would not be “dissolved, liquidated, or merged into another Company.” *Id.*

state tax liability of \$881,627.74.⁷¹ The transaction enabled ProLogis to obtain a stepped-up basis in the property. Shortly thereafter, Tarcon shareholders completed their stock sale to MidCoast.⁷² The purchase price of the stock was equal to Tarcon's cash on hand—\$3,092,052.54—less 56.25% of Tarcon's tax liabilities—\$495,915.60.⁷³ After the sale, "Tarcon shareholders had no further communications with MidCoast or knowledge with respect to Tarcon's funds."⁷⁴ Tarcon shareholders reported the gain from the sale of the Tarcon stock on their individual income tax returns.⁷⁵

MidCoast then sold Tarcon to a Bermuda company, Sequoia Capital, L.L.C., which subsequently purchased and sold "inflated basis assets" to generate losses for Tarcon.⁷⁶ When Tarcon filed its 2003 corporate return, it claimed these large losses to offset the gains from the sale of the Tarcon assets.⁷⁷ As a result, Tarcon paid no taxes.⁷⁸ The IRS determined that the overall transaction was "substantially similar to a [Midco] transaction" or, in the alternative, substantively "a sale of the Tarcon assets to ProLogis followed by a redemption of Tarcon stock owned by the Tarcon shareholders."⁷⁹ Thus, the IRS denied Tarcon's reported losses and determined a tax deficiency in the amount of \$855,237.⁸⁰ Although Tarcon did not contest the determination, Tarcon

71. *Id.* at 1285.

72. *See id.* at 1285. In Notice 2001-16, the IRS describes a Midco transaction as one in which the selling shareholders first sell their stock to an intermediary. I.R.S. Notice 2001-16, 2001-1 C.B. 730. It is only after the sale of the stock that the target corporation sells its assets to a purchaser. *See id.* In *Starnes*, on the other hand, the target corporation sold its assets to the purchaser *before* the selling shareholders sold their stock to the intermediary. *See Starnes*, 101 T.C.M. (CCH) at 1285. In Notice 2008-111, however, the IRS clarified that a transaction can be a Midco transaction irrespective of the order in which the target's stock or assets are disposed. I.R.S. Notice 2008-111, 2008-51 I.R.B. 1299.

73. *Id.* MidCoast only saved the Tarcon shareholders 54.75% in corporate-level taxes. *See id.* The other 56.25% of the tax liability that was deducted from the purchase price of the Tarcon stock was likely intended to be MidCoast's service fee for providing its tax attributes to the selling shareholders to offset Tarcon's gain. *See Avent & Rubirosa, supra* note 8, at 7.

74. *Starnes*, 101 T.C.M. (CCH) at 1286.

75. *Id.*

76. *Id.* at 1285, 1289. Sequoia purchased Tarcon from MidCoast for \$2,861,465.96. Opening Brief for the Appellant, *supra* note 68, at 15.

77. *Starnes*, 101 T.C.M. (CCH) at 1286.

78. *Id.*

79. *Id.* at 1286-87.

80. *Id.* at 1286. The deficiency primarily resulted from the IRS's disallowance of losses claimed for property and interest rate swap options sold on December 31, 2003,

had already transferred all of its cash out of the corporation shortly after the sale of its assets, thereby taking the cash out of the IRS's reach.⁸¹ As a result, the IRS was unable to collect on any portion of the tax from Tarcon directly.⁸² The IRS then pursued the selling shareholders of the Tarcon stock as transferees pursuant to § 6901, contending that Tarcon's transfer of its assets outside of the IRS's reach was fraudulent.⁸³

B. The Holding

In analyzing the shareholders' liability as transferees, the Tax Court noted that the existence and extent of transferee liability was governed by the laws of North Carolina, the state where the transfer occurred.⁸⁴

and reported on Tarcon's Form 4797, Sales of Business Property, for the 2003 tax year. *Id.* The tax due was determined mainly by reference to the tax attributable to Tarcon's sale of the Granite Street property to ProLogis. Opening Brief for the Appellant, *supra* note 68, at 16. The IRS also applied an accuracy-related penalty under § 6662(h) in the amount of \$342,094. *Starnes*, 101 T.C.M. (CCH) at 1286. "Tarcon did not file a petition with [the Tax] Court [necessary] to contest the IRS determinations outlined in the notice of deficiency." *Id.*

81. See Opening Brief for the Appellant, *supra* note 68, at 15. Following the closing of the ProLogis and MidCoast sales, MidCoast transferred \$3,092,052.54 to a new bank account in Tarcon's name. *Id.* MidCoast then sold Tarcon to Sequoia for \$2,861,465.96. *Id.* Two days after MidCoast sold Tarcon to Sequoia, Tarcon transferred all of its funds to an account with Deutsche Bank in its own name. *Id.* Then, on December 1, 2003, Tarcon transferred \$2,960,000 from the Deutsche Bank account to an account located in the Cook Islands in the name of Delta Trading Partners and transferred \$126,822 to a MidCoast bank account. *Id.* After these transfers, Tarcon never had more than \$132,320 in any of its accounts. *Id.*

82. *Starnes*, 101 T.C.M. (CCH) at 1286. Because Tarcon did not pay any portion of the assessment, "in March 2008 the IRS filed Federal tax liens with the Clerk of Superior County, Monroe, North Carolina; the Clerk of Superior Court Mecklenburg County, Charlotte, North Carolina; the North Carolina Secretary of State, Raleigh, North Carolina; and the County Recorder Clark County, Las Vegas, Nevada." *Id.*

83. *Id.* at 1287.

84. *Id.* Although under *Commissioner v. Stern*, state law governs the substantive liability of a transferee, in *Ginsberg v. Commissioner*, the Second Circuit held that federal law governs the procedure for enforcing such liability. *Comm'r v. Stern*, 357 U.S. 39, 47 (1958); *Ginsberg v. Comm'r*, 305 F.2d 664, 667 (2d Cir. 1962). Under federal law, transferees may be subject to personal liability on property transfers pursuant to § 6901. I.R.C. § 6901 (2006).

The substantive law determinative of § 6901 transferee liability can vary from state to state. See James K. Brown, *Transferee Liability and the C Reorganization*, 40 U. COLO. L. REV. 380, 398 (1968). If all participants and assets involved in the transaction are located in the same state, choosing which state's laws to apply is relatively straightforward. *Id.* The choice of law rules become more complicated, however, when multiple states are involved. *Id.* Federal cases provide little guidance because not many have dealt directly with this problem. *Id.* One option to resolve the issue is for the court to rely on federal choice of law rules to determine the applicable state law. *Id.* Alternatively, the court can rely on the choice of law rules of the state in which it sits to determine the applicable state law, as is required in diversity cases. *Id.* at 398 n.126

North Carolina had adopted the Uniform Fraudulent Transfer Act (UFTA),⁸⁵ which provides that a transfer made by a debtor is fraudulent if the debtor made the transfer without receiving a reasonably equivalent value for the transfer and the debtor

- (a) [w]as engaged in or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- (b) [i]ntended to incur, or believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due.⁸⁶

The IRS argued that the stock sale and subsequent transfer of the funds out of Tarcon should be viewed as a single integrated transfer under the

(citing *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496–97 (1941)). Even though liability pursuant to § 6901 rests on state law, because the section enforces a federal right, the courts can utilize federal rather than state choice of law rules in determining which state's laws should apply. *See Brown, supra*, at 398 n.126.

When applying choice of law rules to fraudulent conveyance cases, courts can adopt several different approaches. *Id.* at 398. One approach is to apply the internal law of the state of the situs of the assets at the time of the transfer. *Id.* The situs rules were thought to protect purchasers' expectations of property rights as well as state control over property located in its jurisdiction. *Id.*

But § 6901 transferee liability is not based on the property rights that the situs rules seek to protect. *Id.* at 399. Rather than attempt to set aside a transferor's conveyance of property, the IRS seeks money damages from the transferee on the grounds that the asset transfer was fraudulent. *Id.* Thus, transferee liability cases are more akin to tort cases than property cases. *Id.* It may be more practical, therefore, for courts to employ the choice of law rules used in tort cases than those used in property cases. *See id.* For instance, the court could apply the laws of the state where the transfer occurred—the state where the agreement was closed. *See, e.g., Adams v. Comm'r*, 70 T.C. 373, 390 (1978), *aff'd*, 688 F.2d 815 (2d Cir. 1982).

85. *Starnes*, 101 T.C.M. (CCH) at 1287 (citing N.C. GEN. STAT. § 39-23.4 (2011)). The UFTA adopted in North Carolina has also been adopted by almost every other U.S. state. *See Legislative Enactment Status: Fraudulent Transfer Act*, UNIFORM LAW COMMISSION, [http://www.uniformlaws.org/LegislativeMap.aspx?title=Fraudulent Transfer Act](http://www.uniformlaws.org/LegislativeMap.aspx?title=Fraudulent%20Transfer%20Act) (last visited June 3, 2012). The Uniform Fraudulent Conveyance Act (UFCA) was the predecessor to the UFTA. *See Richard J. Szemiot, Legislative Summary, The Uniform Fraudulent Transfer Act—1988 N.J. Sess. Law Serv. 74 (West)*, 13 SETON HALL LEGIS. J. 101, 101 (1990). One difference between the two acts is that under the UFCA, a creditor was required to demonstrate a lack of both fair consideration and good faith to establish a fraudulent transfer, whereas under the UFTA, a creditor only has to demonstrate a lack of fair consideration. *Id.*

86. *Starnes*, 101 T.C.M. (CCH) at 1287 (citing N.C. GEN. STAT. § 39-23.4).

UFTA.⁸⁷ It took the position that Tarcon transferred the money out of the IRS's reach without receiving equivalent value.⁸⁸

The court held that the party seeking to establish transferee liability must prove that the multiple transactions were linked by showing that the purported transferee had "actual or constructive knowledge of the entire scheme."⁸⁹ Prior to the stock sale, a MidCoast representative provided Tarcon's agent with an informational brochure claiming the Tarcon shareholders would recognize numerous benefits by selling their stock to MidCoast, including the "maximized net after-tax proceeds."⁹⁰ As such, negotiations for the sale of the stock focused primarily on the percentage of Tarcon's outstanding tax liabilities that would be applied to reduce the share purchase price.⁹¹ Nevertheless, the court found the brochure alone did not sufficiently establish that the shareholders had actual knowledge of MidCoast's scheme because the shareholders were not aware of Tarcon's postclosing activities.⁹² The court also explicitly noted, rather incongruously, that further inquiry by the shareholders was "likely warranted" considering they received proceeds in excess of cash on hand less calculated tax liabilities.⁹³ Additionally, the court held that the IRS had not proven that the Tarcon shareholders should have inquired further simply by alleging that the shareholders could not have believed that MidCoast planned to generate a profit with Tarcon.⁹⁴ Thus, the court found the shareholders did not have constructive knowledge of the scheme.⁹⁵ Accordingly, the court refused to collapse the stock sale and Tarcon's subsequent transfer of the funds into a single transaction to determine whether Tarcon received reasonably equivalent value because

87. *Id.* at 1288; M. Levine & A. Roberts, *Tax Court Finds Taxpayers Not Liable as Transferees in Two MIDCO Transaction Cases*, FOCUS ON TAX CONTROVERSY & LITIG., Mar. 2011, at 10, 15.

88. *Starnes*, 101 T.C.M. (CCH) at 1288; Levine & Roberts, *supra* note 87, at 15.

89. *Starnes*, 101 T.C.M. (CCH) at 1289. Ordinarily, a successful fraudulent conveyance action enables the IRS to have the transaction avoided, thereby causing the fraudulently conveyed property to be returned to the transferor as if the conveyance had never occurred. *See* Steve Johnson & E.L. Wiegand, *Using State Fraudulent Conveyance Law To Collect Federal Taxes*, NEV. LAW., June 2006, at 14, 14. This enables the IRS to proceed against the transferor. *Id.* In a transferee liability case, however, the IRS does not seek to set the transaction aside but rather seeks to recover a money judgment from the transferee. *See id.*

90. *Starnes*, 101 T.C.M. (CCH) at 1284.

91. *See id.* at 1285.

92. *See id.* at 1289.

93. *Id.*

94. *Id.*; Forsberg, *supra* note 67.

95. *See Starnes*, 101 T.C.M. (CCH) at 1289; Forsberg, *supra* note 67.

the shareholders lacked both actual and constructive knowledge of the scheme.⁹⁶

Instead, the court ignored the subsequent transfer of the funds and only evaluated whether Tarcon received reasonably equivalent value in the stock sale in order to determine if the shareholders could be found liable as transferees.⁹⁷ The court found that Tarcon did receive reasonably equivalent value in the transaction because MidCoast did not merely provide a circular flow of cash for the stock but rather introduced a fresh “infusion of cash” into the transaction when it paid \$2,596,136.94 for the Tarcon stock.⁹⁸ Thus, the court rejected the IRS’s theories under the

96. See *Starnes*, 101 T.C.M. (CCH) at 1289; Forsberg, *supra* note 67. Arguably, the court should not have used a “knowledge of the entire scheme” standard to begin with in evaluating whether or not to extend transferee liability to the shareholders. See Opening Brief for the Appellant, *supra* note 68, at 52. Rather, the court should have applied the substance over form doctrine, which does not include an evaluation of whether the shareholders had a tax-avoidance motive. See *id.* at 51–53. Courts have applied this standard to many constructive distribution cases “where there was no suggestion of any nefarious scheme.” *Id.* at 53; see, e.g., *Wall v. United States*, 164 F.2d 462, 464 (4th Cir. 1947) (holding that when a corporation satisfies the personal debt of its shareholders, it is as if the corporation paid a dividend to the shareholders who subsequently used this payment to satisfy the debt).

97. See *Starnes*, 101 T.C.M. (CCH) at 1288–89.

98. *Id.* at 1288. Typically, the intermediary arranges financing for the purchase of the stock through a bridge loan, which is secured by the assets of the target company. See *Avent & Rubirosa*, *supra* note 8, at 10. Contemporaneously with or shortly after the stock sale, the intermediary sells the target’s assets to another buyer. See *id.* The bridge loan is then repaid from the proceeds, and the intermediary retains any excess proceeds as a fee for its services. See *id.* This circular cash flow makes it more likely that the IRS will determine that the transaction is an intermediary transaction tax shelter. See *id.*

UFTA⁹⁹ and determined that the shareholders were not liable as transferees for Tarcon's tax deficiency.¹⁰⁰

C. Starnes's Significance

When the dust settled after *Starnes*, ProLogis obtained the Tarcon assets with a stepped-up basis, Tarcon shareholders avoided paying approximately \$385,712 in corporate-level taxes, MidCoast sold Tarcon

99. The court also refused to find the shareholders liable as transferees under North Carolina's trust fund doctrine. *See Starnes*, 101 T.C.M. (CCH) at 1290–91. North Carolina law allows certain claims against dissolved corporations to be enforced against their shareholders. N.C. GEN. STAT. § 55-14-08 (2011). But the court determined that the trust fund doctrine was inapplicable in *Starnes* because the IRS had “not presented evidence regarding circumstances that existed amounting to a winding up or dissolution of Tarcon aside from claiming that Tarcon no longer had a business activity.” *Starnes*, 101 T.C.M. (CCH) at 1291. At the time the Tarcon shareholders sold their stock to MidCoast, however, Tarcon had “no assets other than approximately \$3.1 million in cash; no liabilities other than approximately \$881,000 in taxes; and no other ‘contracts, agreements, obligations, undertakings or commitments.’” Opening Brief for the Appellant, *supra* note 68, at 42. Based on this economic reality, it appears that the shareholders did indeed liquidate Tarcon, and the court therefore should have considered the trust fund doctrine. *See id.* at 40.

100. *Starnes*, 101 T.C.M. (CCH) at 1290–91. By emphasizing that Tarcon received reasonably equivalent value not only because the Tarcon shareholders received cash for their stock but also because this cash was a fresh “infusion of cash” rather than a circular flow of cash, the court suggested that transactions involving intermediaries using their own cash rather than a bridge loan to finance a stock purchase are more likely to be viewed as legitimate. *See id.* at 1288. This could open the door for shareholders to successfully shelter corporate gains by infusing cash into transactions that otherwise mirror intermediary transaction tax shelters. *See id.*

Moreover, the court's determination that there was an infusion of cash in *Starnes* may have been misguided. *See* Opening Brief for the Appellant, *supra* note 68, at 63. In coming to this conclusion, the court relied on evidence that MidCoast paid \$2,596,136.94 for the Tarcon stock and Tarcon received \$3,092,052.54 in a “post-closing bank account.” *Id.* at 62. But in the actual terms of the share-purchase agreement, the shareholders were not required to transfer Tarcon's \$3,092,052.54 to a postclosing bank account in Tarcon's name. *See id.* Rather, “it required the Shareholders to transfer the funds prior to the closing to a trust account at Moore & Van Allen, and then, on the day of the closing, to transfer the funds ‘to the Purchasers,’ *i.e.*, MidCoast.” *Id.* (citations omitted). This indicates that MidCoast intended to immediately receive back the purchase money rather than infuse it into the transaction. *See id.* at 63. Even though MidCoast deposited the cash into a newly established Tarcon bank account the next day, it drained this Tarcon bank account just three weeks later by transferring the funds offshore. *See id.* at 63–64. But the court collapsed the shareholders' transfer of Tarcon's cash to MidCoast and MidCoast's subsequent transfer of the cash to a Tarcon bank account, and thus found that MidCoast infused cash into the transaction. *See id.* at 64.

For the sake of consistency, it would follow that the court would also collapse MidCoast's later transfer of the cash *out* of Tarcon, thereby finding the shareholders liable for the fraudulent transfer as transferees. *See id.* Yet the court refused to do so because the shareholders lacked knowledge of Tarcon's postclosing activities. *See Starnes*, 101 T.C.M. (CCH) at 1288–89.

to Sequoia, which offset Tarcon's entire tax liability of \$881,627.74 with other losses, and the IRS was unable to collect Tarcon's unpaid taxes from either Tarcon or its shareholders.¹⁰¹ The results of the case are strikingly similar to those once permitted under the *General Utilities* doctrine.¹⁰² In response to a 1983 staff report of the Senate Finance Committee concerning corporate income tax reform, an American Bar Association task force identified several areas where the *General Utilities* doctrine presented problems.¹⁰³ One of the major problems noted in the task force report was that "double tax[ing]" interim distributions but only "single tax[ing]" the sale and subsequent liquidation of corporate assets could result in serious revenue losses.¹⁰⁴ Corporations with highly appreciated inventory that would ordinarily distribute current earnings via dividends could reduce the tax liability on their inventory by almost 75% if they sold all of their assets and liquidated.¹⁰⁵ Moreover, the Joint Committee on Taxation stated in its 1986 annual tax expenditure estimate that for the five-year period from 1987 to 1991, the tax preference created by the *General Utilities* doctrine was estimated to decrease corporate and individual income tax liabilities by \$26.1 billion.¹⁰⁶

101. See *id.* at 1285–87, 1291.

102. See *Avent & Rubirosa*, *supra* note 8, at 3–4.

103. Task Force, Am. Bar Ass'n Section of Taxation, *Income Taxation of Corporations Making Distributions with Respect to Their Stock*, 37 TAX LAW. 625, 625 (1984). The 1983 Senate Finance Committee Staff Report to which the task force report was a reaction proposed that a corporation that distributes appreciated property to its shareholders should recognize gain. See STAFF OF S. COMM. ON FIN., 98TH CONG., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 6–7 (Comm. Print 1983).

104. Task Force, *supra* note 103, at 631–32.

105. *Id.* at 632.

106. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1987–1991 12 tbl.1 (Comm. Print 1986). But in April 1985, the estimate was \$60.9 billion over the five-year period from 1986–1990. See STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1986–1990 14 tbl.1 (Comm. Print 1985). The Joint Committee did not provide an explanation as to why there was such a large discrepancy between the 1985 and 1986 Reports. See Yin, *supra* note 39, at 1116 n.57. In the 1986 Report, the Joint Committee listed 133 separate tax expenditure items, and the tax preference created by the *General Utilities* doctrine was the twenty-second largest. *Id.* at 1116–17. It surpassed items including

the use of percentage depletion in the oil and gas industry; the special capital gains treatment for timber; the rehabilitation tax credit; the special bad debt reserve rules of financial institutions; the exclusion of capital gains on home sales for persons 55 or over; the exclusion of interest on state and local government industrial development bonds; the exclusion of interest on state and local government bonds for owner-occupied and rental housing; the credit

The result in *Starnes* could effectively lead to a return to a drastic and unwarranted reduction in corporate and individual taxes. Even though Tarcon's agent was aware of the tax benefits of the stock sale, the court found that in order to collapse the stock sale and asset transfer, the shareholders had to have actual or constructive knowledge of the scheme itself.¹⁰⁷ This included "the sale of Tarcon to Sequoia and Sequoia's subsequent purchase and sale of 'inflated basis assets' to purportedly generate losses for Tarcon."¹⁰⁸ Requiring the IRS to show that shareholders involved in Midco transactions were aware of *entire schemes* to establish transferee liability imposes an impossibly high burden on the IRS.¹⁰⁹ It also encourages "don't ask, don't tell" conduct by the parties to these transactions that borders on conspiracy. As long as shareholders do not inquire into the details of any subsequent schemes by promoters, they may be able to plan similar transactions for the purpose of receiving tax benefits without being found liable as transferees.¹¹⁰

The court also respected the stock sale as an independently legitimate transaction simply because MidCoast used an "infusion of cash" to purchase the Tarcon stock.¹¹¹ This is in contrast to a typical Midco transaction where the intermediary uses funds obtained via a bridge loan to purchase the target stock and then uses the target assets to repay the loan, thereby placing the assets out of the IRS's reach.¹¹² In *Starnes*, even though the intermediary did not use the Tarcon assets to repay a bridge loan, the assets were nevertheless transferred out of the IRS's reach.¹¹³ The result in both an ordinary bridge loan Midco transaction and *Starnes* is therefore the same.¹¹⁴ Nevertheless, the court did not scrutinize the stock purchase in *Starnes* because MidCoast introduced its own funds into the transaction rather than funds obtained via a bridge loan.¹¹⁵ The court sent the message that shareholders looking to legitimize their Midco-like transactions need only require that the participating

for child care expenses; the exclusion of Workmen's Compensation benefits; and the exclusion of premiums on group-term life insurance.

Id. at 1117.

107. See *Starnes v. Comm'r*, 101 T.C.M. (CCH) 1283, 1288–89 (2011), *aff'd*, 680 F.3d 417 (4th Cir. 2012).

108. *Id.* at 1289.

109. See Opening Brief for the Appellant, *supra* note 68, at 54.

110. See *id.* at 55 ("The court's standard . . . enables participants in an intermediary tax shelter to easily defeat transferee liability, by choosing willful blindness of the promoter's tax-avoidance intentions and then claiming ignorance of the 'entire scheme,' as the Shareholders did here.").

111. *Starnes*, 101 T.C.M. (CCH) at 1288.

112. See *supra* note 98.

113. See *supra* note 100.

114. See *supra* notes 98, 100.

115. See *supra* note 100 and accompanying text.

intermediary use a fresh infusion of cash, even if the results are virtually identical to those of an ordinary Midco transaction.¹¹⁶

V. CONCLUSION

Starnes allows shareholders to circumvent congressional intent to impose two levels of taxation upon the sale of corporate assets. If selling shareholders lack actual or constructive knowledge of an intermediary's entire postclosing scheme and the intermediary uses a fresh "infusion of cash" to purchase target stock, then under *Starnes*, these shareholders can engage in Midco-like transactions to shelter a target's corporate-level tax while purchasers nevertheless receive a stepped-up basis in the acquired target assets.¹¹⁷ This could effectively resurrect the *General Utilities* doctrine for closely held corporations and, arguably, others as well. *Starnes* thus presents an opportunity to substantially reduce corporate tax liabilities that can be exploited by parties to such transactions.¹¹⁸ But the *Starnes* holding marks a clear departure from the standing twenty-five year repeal of the *General Utilities* doctrine, and thus, courts may interpret the case narrowly in the future. Indeed, in *Feldman v. Commissioner*, another Midco case decided after *Starnes*, the Tax Court held that a target company's shareholders were liable as transferees because the intermediary's offer of a "'no-cost' liquidation" as a solution to the shareholders' "tax 'dilemma'" was enough to put the shareholders on notice of the intermediary's tax-avoidance scheme.¹¹⁹ The IRS is likely to pursue a zealous campaign of challenges to the *Starnes* holding at every opportunity until it is ultimately overturned or so narrowly construed as to be without effect. Corporations would be well advised to be cautious in relying on this case for aggressive tax planning until there

116. See *supra* notes 96, 100.

117. See *Starnes v. Comm'r*, 101 T.C.M. (CCH) 1283, 1286–91 (2011), *aff'd*, 680 F.3d 417 (4th Cir. 2012).

118. See Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 14 (2010) (noting that sophisticated taxpayers often create "convoluted structures" in an attempt to "achieve tax-favorable results").

119. *Feldman v. Comm'r*, 102 T.C.M. (CCH) 612, 623 (2011). In another Midco case decided on the same day as *Feldman*, the Tax Court found in favor of the taxpayers. See *Frank Sawyer Trust of May 1992 v. Comm'r*, 102 T.C.M. (CCH) 623, 624 (2011). As in *Starnes*, the court determined that the taxpayers were not liable as transferees because they had no actual or constructive knowledge of the purchaser's postclosing intentions and the stock sale was financed by a bank loan. See *id.* at 627, 632.

is more precedent, or they may risk finding themselves in court as a new “test case” for fraud in an IRS-initiated *Starnes* challenge.